

No. 16,004

United States Court of Appeals
For the Ninth Circuit

THE IDAHO FIRST NATIONAL BANK,
Appellant,

vs.

UNITED STATES OF AMERICA,
Appellee.

Appeal from the United States District Court
for the District of Idaho,
Southern Division.

BRIEF OF APPELLANT.

MYRON E. ANDERSON,
Idaho Building, Boise, Idaho,

ANDERSON, KAUFMAN AND ANDERSON,

EUGENE H. ANDERSON,
Idaho Building, Boise, Idaho,

Attorneys for Appellant.

FILED

JUL 29 1958

PAUL P. O'BRIEN, CLERK

INDEX

	Page
Statutes and regulations	1
Statement of pleadings and facts disclosing basis of jurisdiction	4
Statement of the case	5
Question presented	8
Specifications of error	9
Argument	9
Relative rights of taxpayer and Commissioner on accounting method and definitions	9
Changes by Commissioner	11
Distribution by corporation on dissolution	12

Table of Cases

	Pages
Cecil v. Commissioner of Internal Revenue, 100 F. 2d 896, 902	11
Glenn v. Kentucky Color & Chemical Co., Inc., 186 F. 2d 975	10
Herbert v. Riddell, 103 F. Supp. 369	13
Hess Co., Henry, Commissioner v., 210 F. 2d 553	13
Horschel, U. S. v., 205 F. 2d 646	13
Huntington Securities Corporation v. Busey, 112 F. 2d 368	10
Martinus & Sons, J. H. v. Commissioner of Internal Revenue, 116 F. 2d 732	11
Mitchell, et al., U. S. v., 46 S. Ct. 419, 271 U. S. 9, 70 L. Ed. 799	11
Osterloh v. Lucas, 37 F. 2d 277	11
Telephone Directory Advertising Company, et al v. U. S., 142 F. Supp. 884	13
Welch v. DeBlois, et al, 94 F. 2d 842	10
Wolf Bakery and Cafeteria Co., T. C. Memo, P.-H. 46, 117 (Docket No. 7899; 5-23-46)	10

Codes

26 U.S.C.A. (Internal Revenue Code (1939)):	
Sec. 22	1
Sec. 29.22(a)20	3, 6
Sec. 29.41-1	3
Sec. 29.41-2	2
Sec. 29.41-3	2
Sec. 29.52-1	3
Sec. 29.115-3	4
Sec. 41	2, 6, 10
Secs. 42 and 43	2
Sec. 48	2
28 United States Code, Secs. 1346(a), 1348 and 1402(a)	4

No. 16,004

**United States Court of Appeals
For the Ninth Circuit**

THE IDAHO FIRST NATIONAL BANK, <i>Appellant,</i>
VS.
UNITED STATES OF AMERICA, <i>Appellee.</i>

**Appeal from the United States District Court
for the District of Idaho,
Southern Division.**

BRIEF OF APPELLANT.

STATUTES AND REGULATIONS.

26 U.S.C.A.: (Internal Revenue Code (1939))

Sec. 22. Gross Income.

(a) General Definition — Gross income includes gains, profits, . . . interest . . .

Sec. 41. (Accounting Period and Methods).
General Rule. The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the

Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in Section 48, or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

Treasury Regulations 111:

Sec. 29.41-2. Bases of Computation and Changes in Accounting Methods. Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48, for definitions of "paid or accrued" and "paid or incurred". All items of gross income shall be included in gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48 . . . A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See sections 29.42-2 and 29.42-3). On the other hand appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property . . .

Sec. 29.41-3. Methods of Accounting. It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law

contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so . . .

Sec. 29.41-1. Computation of Net Income. Net income must be computed with respect to a fixed period . . . If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for . . .

Sec. 29.52-1. Corporation Returns. Every corporation not expressly exempt from tax must make a return of income, regardless of the amount of its net income . . . A corporation having an existence during any portion of a taxable year is required to make a return. If a corporation was not in existence throughout an annual accounting period (either calendar year or fiscal year), the corporation is required to make a return for that fractional part of the year during which it was in existence. A corporation is not in existence after it ceases business and dissolves, retaining no assets, whether or not under state law it may thereafter be treated as continuing as a corporation for certain limited purposes connected with winding up of its affairs such as for the purpose of suing and being sued . . .

Sec. 29.22(a)20. Gross Income of a Corporation in Liquidation. When a corporation is dissolved . . . No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation,

however they may have appreciated or depreciated in value since their acquisition . . .

Sec. 29.115-3. Earnings or Profits. In determining the amounts of earnings or profits . . . due consideration must be given to the facts, . . . the amount of earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42 and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; . . .

**STATEMENT OF PLEADINGS AND FACTS DISCLOSING
BASIS OF JURISDICTION.**

Complaint was filed by The Idaho First National Bank, appellant, against the United States, respondent, in the District Court of the United States for the District of Idaho, Southern Division, for the recovery of income taxes theretofore paid. Jurisdiction was based upon Title 28 United States Code, Secs. 1346(a), 1348 and 1402(a). (Tr. pages 3 to 11.) The cause was placed at issue by Answer of the United States. (Tr. pages 12 to 16.) The cause was tried and submitted for decision on Stipulations of Fact, the Hon. William Healy, acting District Judge, presiding. (Tr. pages 16 to 23.) Findings of Fact and Conclusions of Law, and Judgment based thereon, in favor of respondent, the United States, were made and entered in the lower court. (Tr. pages 24 to 32.) The Idaho First National Bank, plaintiff below and appellant here, appealed to this court from the Judgment.

STATEMENT OF THE CASE.

Wendell National Bank, a corporation with its banking house at Wendell, Idaho, operated for many years. On May 10, 1952 appellant Idaho First National Bank purchased from the stockholders of Wendell National Bank the entire capital stock of the latter corporation. The purchase was for the sole purpose of acquiring the assets of the Wendell bank.

Immediately thereafter and on the same day as the purchase of the stock, Wendell bank was voluntarily dissolved and all of its assets and liabilities distributed to appellant.

Included in the assets were the notes evidencing the outstanding loans of the Wendell bank which were not due nor payable. The notes bore interest which was not due nor payable.

The Wendell bank had consistently reported its net income for tax purposes on the cash basis method of accounting. Its cash basis method covered both its gross income and its deductions. It reported on a calendar year basis.

However, the appellant, as transferee of the assets, caused income tax return to be filed for the Wendell bank for the period January 1, 1952 through May 10, 1952, reporting as income the amount of the interest on the notes computed to the time of dissolution and distribution, although such interest was neither due nor payable, and the notes unmatured. The unpaid expenses and deductible items, however, were not computed nor used as a deduction against income in the tax return.

Subsequently, examination of such tax return was made by the Internal Revenue Service, which, upon such examination, eliminated such interest from income of the Wendell bank, on the ground that such interest was not taxable income to the Wendell bank for the reason that it was a cash basis taxpayer. The portion of the tax attributable to the interest was refunded to the appellant.

Thereafter, the Internal Revenue Service re-examined the tax return of the Wendell bank, and reversed its decision, and included such interest in income in the period covered by the tax return. Its reason appearing in the Stipulations of Fact, Section 13 (Tr. pages 27 and 28) is quoted as follows:

“The substance of the above ruling and the cited cases is that where the taxpayer liquidating corporation has performed substantially all the services necessary to establish its right to the income, the Commissioner is within his rights under Section 41 to change the method of determining income to include such items, Section 22 (a) (20) relating to the gross income of corporation in liquidation notwithstanding.”

It appears obvious that the reference to “Section 22(a)(20)” is in error. The Commissioner must have intended to refer to Regulation 111, Sec. 29.22(a)-20. The Section 41 referred to is obviously Section 41 of the 1939 Internal Revenue Code. (Title 26 USCA Sec. 41) (1939).

The appellant as transferee of the assets, paid the tax assessed, filed application for refund which was denied, and instituted this action.

The amount of the interest involved was finally determined to be \$13,191.19 and the amount of tax involved \$3,957.36 plus interest.

The calculation and computation by the Commissioner included in income only the interest, which interest was neither due nor payable at the date of dissolution. No calculation, computation, or other consideration, was given to any of the unpaid expenses or deductions of Wendell Bank, attributable to the period covered by the tax return.

It is the position of appellant that:

A taxpayer may compute its income, and make its income tax returns, on a cash basis; the selection of the cash basis system is lodged exclusively in the taxpayer provided it is within the statutory limits of clearly reflecting income for tax purposes and such method must be consistent from year to year; if the taxpayer's method of accounting clearly reflects income, statute is mandatory on both taxpayer and Commissioner that taxable income be determined in accordance therewith;

That the word "clearly" within the statute permitting taxpayer to make its income tax return on cash basis in accordance with method of accounting regularly employed in keeping its books, means plainly, honestly, straightforwardly and frankly;

That the word "method" within the statute permitting taxpayer to make income tax return on a cash basis means the way of keeping the taxpayer's books according to a defined and regular plan; and, only where the "method" (being a way of keeping

taxpayer's books according to a defined and regular plan) does not clearly reflect income, can the Commissioner change the method.

It is further the position of appellant that the decision of the Commissioner is not actually a change of method.

It is the further position of appellant that:

The distribution to shareholders of accrued items of income, in the process of dissolution and distribution of a cash basis corporate taxpayer, is not an assignment of anticipatory income;

That where the shareholders of a fully dissolved corporation receive money or other property which would have been taxable income to the corporation at the time, if the corporation were still in existence, the corporation is not taxable thereon; and,

That upon liquidation and distribution of the assets of a corporation, to the shareholder, income derived from the property is taxable to the recipient of the distributed share, and not to the corporation.

QUESTION PRESENTED.

Where a banking corporation has consistently reported its income and deductions for income tax purposes, including its interest income, on a cash receipts and disbursements method of accounting, can the Commissioner, in the year of its liquidation, include in income, interest which was neither due nor payable on unmatured notes, in order to make such interest taxable income to such banking corporation in the tax period ending with its liquidation.

SPECIFICATIONS OF ERROR.

The court erred in its concluding as a matter of law (Tr. page 30), that the position taken by the respondent in this case is warranted by statute and has ample support in the decisions.

The court erred in concluding as a matter of law (Tr. page 30) that the interest on notes receivable, which interest was neither due nor payable, in the taxable period ending with the liquidation of the Wendell bank, is taxable as income to it in that period, notwithstanding the fact that it reported its income for tax purposes on the cash receipts and disbursements basis.

The court erred as a matter of law in concluding (Tr. page 30) that judgment be entered in favor of defendant and dismissing plaintiff's complaint.

ARGUMENT.

RELATIVE RIGHTS OF TAXPAYER AND COMMISSIONER ON ACCOUNTING METHOD AND DEFINITIONS.

The Wendell bank, for many years, consistently reported its income for tax purposes on a cash receipts and disbursements method of accounting. Its right to do so is well founded in the Internal Revenue Acts, Regulations and Decisions.

Selection of this basis or system of accounting was lodged exclusively with the Wendell bank, with only one proviso, namely, that such method clearly reflect income for tax purposes and that such method be consistent from year to year. If such method clearly

reflects income, then the statute, (Sec. 41 of the Internal Revenue Code) (Tit. 26, 1948 Edition, USCA, Sec. 41; Tit. 26 U.S.C.A. Int. Rev. Code 1939 as amended, Sec. 41) is mandatory on both the taxpayer and Commissioner that the taxable income be determined in accordance therewith.

Huntington Securities Corp. v. Busey, 112 F. 2d 368;

Glenn v. Kentucky Color etc., 186 F. 2d 975.

The courts have defined the word "clearly" as used in the statute to mean plainly, honestly, straightforwardly and frankly. The courts have distinguished between the words "clearly" and "accurately", stating that the cash receipts and disbursements method of accounting frequently does not accurately reflect earned or partially earned income or incurred or partially incurred expense. The courts have defined the word "accurately" in the ordinary use of the term to mean precisely, exactly, correctly and without error or defect and have distinguished such expressions from the word "clearly" as used in the statute.

Huntington Securities Corp. v. Busey, 112 F. 2d 368;

Welch v. DeBlois, 94 F. 2d 842;

Wolf Bakery and Cafeteria Co., T. C. Memo, P.-H. 46,117, (Docket No. 7899; 5-23-46).

The courts have defined the word "method" as used in the statute as being according to a way of keeping the taxpayer's records according to a defined and regular plan.

Huntington Securities Corp. v. Busey, 112 F. 2d 368.

Here we have a taxpayer which for many years used the cash receipts and disbursements method, which method was consistent, and which clearly reflected income. Its income which had been received and its expenses which had been disbursed, as clearly reflected its net income as a cash basis taxpayer in the year of its liquidation as in any prior year.

The courts have held that a taxpayer reporting on a purely cash receipts and disbursements method, has no right to accrue either receipts or disbursements, and have held that the method consistently followed may affect either the taxpayer or the government adversely from time to time, but that the fact that it may affect either the taxpayer or the government adversely is not reason for either the Commissioner or the taxpayer to change the method.

Cecil v. Commissioner of Internal Revenue,
100 F. 2d 896;

Osterloh v. Lucas, 37 F. 2d 277;

J. H. Martinus & Sons v. Commissioner of Internal Revenue, 116 F. 2d 732;

United States v. Mitchell, 46 S. Ct. 419, 271 U.S. 9, 70 L. Ed. 799.

CHANGES BY COMMISSIONER.

In this case, the Commissioner has selected a classification of income, namely interest, on loans made by the bank evidenced by notes which had not matured, and the interest on which was not due nor payable. Admittedly, interest on this type of obliga-

tion is the main source of a bank's income; and, on some of the notes the interest had been accruing from during the prior year.

The Commissioner has accrued such interest income into the taxable year of liquidation, solely because of the liquidation. The determination of the Commissioner was made solely for the reason that the banking corporation had liquidated.

Had the Wendell bank continued in existence, it could hardly be said that the Commissioner would have been entitled to make any such a change, either in the year involved here or in any other year.

The Wendell bank, as every bank, has expenses attributable to the production of income and to the production of its interest to be received on its outstanding loans. Such expenses include but are by no means limited to, ad valorem and other taxes not due at the time of liquidation. None of the expenses were accrued by the Commissioner to the time of liquidation nor for the taxable period in the year of liquidation.

The acts of the Commissioner created a distortion of income in the taxable period in question.

DISTRIBUTION BY CORPORATION ON DISSOLUTION.

This court has held that distribution to the shareholders of accrued items of income, in the process of dissolution and distribution of a cash basis corporate taxpayer, is not an assignment of anticipatory

income and has held that where such shareholders receive money or other property which would have been taxable income to the corporation at the time if it were still in existence, the corporation is not taxable thereon. Upon liquidation and distribution of the assets of a corporation, to its shareholders, income derived from the property is reportable by the recipient of the distributed share.

United States v. Horschel, 205 F. 2d 646;
Commissioner of Internal Revenue v. Henry Hess Co., 210 F. 2d 553;
Herbert v. Riddell, 103 F. Supp. 369;
Telephone Directory Advertising Co. v. United States, 142 F. Supp. 884.

The lower court should be reversed.

Dated, Boise, Idaho,
 July 11, 1958.

MYRON E. ANDERSON,
 ANDERSON, KAUFMAN AND ANDERSON,
 By EUGENE H. ANDERSON,
Attorneys for Appellant.

(Appendix Follows.)

Appendix.

Appendix

Exhibits	Identified, Offered and Received in Evidence
EXHIBIT A. Resolution for dissolution and distribution of assets of Wendell National Bank	Tr. 18 (Stip. No. 5)
EXHIBIT B. Affidavit of Virginia Dodge, C.P.A., that Wendell National Bank reported its income on cash basis of accounting	Tr. 18 (Stip. No. 8)
EXHIBIT C. Copy of income tax return of Wendell National Bank for period January 1, 1952 to May 10, 1952	Tr. 19 (Stip. No. 9)
EXHIBIT D. Claim for refund	Tr. 22 (Stip. No. 20)
EXHIBIT E. Federal income tax return of Austin and Eda Schouweiler for the year 1952	Tr. 23 (Stip. No. 23)
EXHIBIT F. Notice of rejection of claim for refund	Tr. 23 (Stip. No. 24)

